

## ***Fair Market Value Versus Investment Value*** **Pricing Transactions**

When buying or selling part or all of a facility, there is almost always confusion about the value of that facility. Does a hospital buyer give consideration for improvements that they know that they can make through better purchasing power? Should a seller of a facility increase the value because a local hospital system can improve margins because of their contracting leverage? Should the value of a surgery center be increased because of expected additional case volumes that a group of investing surgeons will bring? These are only a few of the questions that come up when a facility transaction is being evaluated.

Fair market value is the valuation standard promulgated by the IRS and other governmental authorities for healthcare transactions. A significant deviation in purchase price from fair market value, while sometimes warranted, should be thoroughly understood, evaluated, and justified.

Any difference in price that a buyer or seller may accept for a healthcare facility as compared to the value indicated in a fair market value analysis will generally result from the potential buyer using a valuation approach other than fair market value to define the purchase price. The most likely definition of value that a potential buyer may use to price a transaction is investment value.

In healthcare services, concerns revolving around private enurement and federal anti-kickback statutes result in a reliance on fair market value as the standard for facility transactions. IRS statutes require tax-exempt hospitals to enter into transactions at a fair market value so as not to enure the benefit of tax-exemption to private parties, a violation of IRS guidelines may result in the loss of tax-exempt status. In transactions that involve hospitals and physicians, the federal anti-kickback statutes dictate that any benefit to physicians in excess of fair market value may be construed as an inducement to refer, as such, all transactions between physicians and hospitals should be consummated at fair market value.

Fair market value is defined by Internal Revenue Service Revenue Ruling 59-60 as “the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.” The most important distinction between fair market value and investment value is that fair market value is determined by the price of a general willing buyer, while investment value is defined by a particular buyer, a price which reflects the particular facts and circumstances of that investor.

Investment value, unlike fair market value, may result in several different valuation outcomes. Investment value is based on an analysis of value to each individual buyer, and in most cases each potential buyer will offer a different price as a result of the

individual outlook and synergies that each buyer brings to the transaction. Importantly, because investment value allows a prospective purchaser the ability to achieve or implement specific attributes that yield a higher value, investment value refers to a majority or control interest.

To illustrate, we consider the case of a hypothetical facility that when appraised using a fair market value standard, has the following valuation result:

| <b>Sample Hospital</b>         |             |
|--------------------------------|-------------|
| Revenue: \$                    | 18,750,000  |
| EBITDA: \$                     | 1,500,000   |
| EBITDA Margin:                 | 8.0%        |
| EBITDA Multiple:               | 4.5         |
| Fair Market Value (TIC): \$    | 6,750,000   |
| Less Associated Debt: \$       | (2,000,000) |
| Fair Market Value (Equity): \$ | 4,750,000   |

The following four scenarios illustrate different instances in which investment value for a specific buyer seeking a control or majority interest may result in a higher price than fair market value. (Total invested capital is defined as all interest-bearing debt plus equity; EBITDA is defined as earnings before interest, taxes, depreciation and amortization).

**Scenario 1:** The investor may be able to provide specific market synergies that increase revenues and/or decrease costs, resulting in a higher pro-forma operating margin:

| <b>Scenario 1: Cost Savings</b>             |                     |
|---|---------------------|
| Current EBITDA: \$                          | 1,500,000           |
| Current EBITDA Margin:                      | 8.0%                |
| Investment Value EBITDA: \$                 | 2,812,500           |
| Investment Value EBITDA Margin:             | 15.0%               |
| Fair Market Value EBITDA Multiple:          | 4.5                 |
| Investment Value EBITDA Multiple:           | 4.5                 |
| Implied Investment Value EBITDA Multiple:   | 7.1                 |
| <i>Fair Market Value of Equity:</i>         | <i>\$4,750,000</i>  |
| Investment Value of Total Invested Capital: | \$12,656,250        |
| Less Associated Debt:                       | (\$2,000,000)       |
| <i>Investment Value of Equity:</i>          | <i>\$10,656,250</i> |

Scenario 2: A publicly traded company purchaser may acquire the hospital at any price that results in a lower valuation multiple than the price of the buyer's stock; the accretive nature of such a transaction may increase the buyer's willingness to pay a higher price:

| <b>Scenario 2: Public Company Buyer</b>     |                     |
|---|---------------------|
| Current EBITDA:                             | \$ 1,500,000        |
| Current EBITDA Margin:                      | 8.0%                |
| Investment Value EBITDA:                    | \$ 1,500,000        |
| Investment Value EBITDA Margin:             | 8.0%                |
| Fair Market Value EBITDA Multiple:          | 4.5                 |
| Investment Value EBITDA Multiple:           | 8.0                 |
| <i>Fair Market Value of Equity:</i>         | <i>\$4,750,000</i>  |
| Investment Value of Total Invested Capital: | \$12,000,000        |
| Less Associated Debt:                       | (\$2,000,000)       |
| <i>Investment Value of Equity:</i>          | <i>\$10,000,000</i> |

Scenario 3: A regional buyer may pay a higher price than fair market value for intangible benefits, which may include the elimination of a competitor, a greater market presence, and the creation of favorable relationships with local physicians:

| <b>Scenario 3: Intangible Synergies</b>     |                    |
|---|--------------------|
| Current EBITDA:                             | \$ 1,500,000       |
| Current EBITDA Margin:                      | 8.0%               |
| Investment Value EBITDA:                    | \$ 1,500,000       |
| Investment Value EBITDA Margin:             | 8.0%               |
| Fair Market Value EBITDA Multiple:          | 4.5                |
| Investment Value EBITDA Multiple:           | 6.0                |
| <i>Fair Market Value of Equity:</i>         | <i>\$4,750,000</i> |
| Investment Value of Total Invested Capital: | \$9,000,000        |
| Less Associated Debt:                       | (\$2,000,000)      |
| <i>Investment Value of Equity:</i>          | <i>\$7,000,000</i> |

Scenario 4: A regional buyer may pay more than fair market value because cost of building a new facility is higher than the fair market value of the current facility:

| <b>Scenario 4: Build versus Purchase New Facility</b> |                     |
|---|---------------------|
| Land:   | \$ 1,000,000        |
| Building:   | \$ 7,500,000        |
| Equipment:  | \$ 6,000,000        |
| Working Capital:                                      | \$ 1,000,000        |
| Start-Up:   | \$ 1,500,000        |
| Total Costs:  | \$ 17,000,000       |
| Less - Current Debt:                                  | \$ 11,000,000       |
| <i>Build-Out Equity Value:</i>                        | <i>\$ 6,000,000</i> |
| <i>Fair Market Value of Equity:</i>                   | <i>\$ 4,750,000</i> |

Frequently, prospective purchase prices are discussed between the buying and selling parties prior to the initiation of a fair market value analysis. In many instances, a purchase price based on investment value considerations may be agreed upon, but due to regulatory factors and/or management concerns, a fair market value analysis prepared by an independent third party must be completed to confirm the proposed purchase price so as to conform to regulatory guidelines. During this process, it is not uncommon for the fair market value analysis to result in a value much different than the proposed purchase

price discussed in preliminary discussions or negotiations. This sort of situation might be the result of consideration given to factors similar to those exemplified in the aforementioned scenarios. As a result, fair market valuations may materially change a proposed purchase price and many transactions are suspended after a fair market value review.

There are, however, rare occasions when investment value considerations can be considered even when a fair market value standard is required. However, as mentioned above, these should be carefully reviewed and documented. Consider, for example, the case where construction of a new facility would be far more expensive than the fair market value of an existing facility as represented by Scenario 4 above. It would be reasonable for a buyer to pay in excess of fair market value for a facility if that buyer could demonstrate that an equivalent new facility would cost more than the fair market value of the existing facility. In this case, a purchase price in excess of fair market value of the existing facility would be a more efficient and prudent use of tax-exempt funds.

It is important to consider a fair market valuation at the front-end of any healthcare transaction that is under regulatory scrutiny. Setting an agreed upon purchase price that abides by regulatory guidelines early in transaction discussions will eliminate purchase price disparities, save both the buyer and seller time and money, and result in more constructive transaction discussions.

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